Drugs Company Profits In The United States: Are They Excessive? Evidence From Public Administration Perspectives

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ABSTRACT

Historically, the drug industry has been one of the most profitable in the United States of America and has been attributed to the relatively high cost of drugs compared to other developed countries. The call on drug companies to reduce the costs has increased tremendously with the industry strongly resisting, claiming costs are justified to support research and development of newer and better drugs. This debate is currently ongoing in the legislature with strong lobbying from both sides of the divide. Hence, the main objective of this research is to determine the reasons for the high cost of prescription drugs in the United States compared to other countries and suggest ways to make drugs more affordable. The solution to the problem will most likely come from a compromise by both sides involving government funded research and production of generic drugs by companies. This would bring down the cost of drugs while ensuring continuation of research and development and guarantee reasonable profits for the drug industry.

INTRODUCTION

In the last 20 years, there has been a steady rise in the cost of prescription drugs in the United States of America compared to the rest of the world. As a result of the economic downturn of the last 4 years and rising drug costs, it has become increasingly difficult for Americans to buy much needed prescription drugs. In response to this, Americans have resorted to buying these drugs from pharmacies in Canada. Were they are averagely about 40% cheaper. This is illegal in the United States because the Food and Drug Administration (FDA) allows importation only by the pharmaceutical companies who produce the drugs. This has also become an issue for the states due to the recent reduction in federal funding of Medicare that has left the states to bear the cost of a larger share.

This new health care cost burden has put severe pressure on states to reduce costs. As a result, there has been a proposal by several states to buy the cheaper Canadian drugs in order to reduce state budget deficits. This plan as well as a reform of the Medicare plan has been strongly resisted by Pharmaceutical companies who want protect their profits. The main objective of this research is to determine the reasons for the high cost of prescription drugs in the United States compared to other countries and suggest ways to make drugs more affordable.

LITERATURE REVIEW

The rising cost of prescription drugs in the Unite states has been a topic of debate for the last 20 years. Historically, the drug industry in America has been the top performing industry in terms of return on revenues (average of 18.6%) and return on assets (average 17.7%) compared to 4.9% and 3.9% respectively for median companies in the Fortune 500 industries. This was also the case in 2002 as the two top companies were drug companies (Pfizer, Return on revenue 28.4% and Eli Lilly, 24.4%). This is way above the highly profitable computer and oil industry returns of between 6% and 12%. There have been several research papers and articles published on this issue.

A significant number of these papers question the rationale for the high cost while others mainly sponsored by pharmaceutical companies and their lobbyists justify these costs. This is an issue that is currently being debated in the federal legislative houses and also by several states and individuals. It has also been one of the campaigning points for the Republican and Democratic parties because the rising drug costs affect mainly the elderly and the poor who are least able to afford any type of health insurance.

DATA SOURCE

The data used for this study has been obtained from various sources. These include the websites for the Pharmaceuticals research and Manufacturers of America (PhRMA), National Institute of Health (NIH), Food and Drug Administration (FDA), Federal department of commerce and the Whitehouse briefing room. In addition to these, several Scholarly journal articles and magazine articles have also been used. These can be grouped into four broad categories; those in favor of retaining the status quo (unregulated monopolies), those in favor of price controls while allowing reasonable profit, those in favor of a competitive market and finally those in favor of a solution that is a combination of two of the earlier solutions. The data used in this study though not exhaustive covers the wide range of issues regarding the cost of prescription drugs in the United States of America.

THE OPPOSITION'S PERSPECTIVE

There has been an increasing clamor for the review of the drug industry by several individuals, legislators and scholars sighting the high cost of drugs that exploit people while reaping huge profits. The basis of this opinion is founded in the following allegations:

The drug companies are patent protected monopolies that have patents that span between 17 and 22 years from discovery and are issued by the federal government. The companies claim that on average, it costs about $802 million over a period of 12 years to bring a drug to the market. This has been disputed by several people claiming that the National Institute of health bears approximately 36% of research costs during the earliest and riskiest portions of the R&D process of basic research and earlier phases of clinical trials.

A large proportion of research by the drug industry is not undertaken to develop breakthrough drugs to treat diseases for which no cure exists. The research is more focused on developing similar successful drugs already developed by competitors who reap high profits. They provide an element of competition for the first successful drug but do not encourage them to carry out research aimed at discovering breakthrough drugs. According to the FDA, about 75% of drugs approved over the last 15 years fall into this category (Baker, 2003). This raises the question, should these drugs be afforded the patent protection given to breakthrough drugs? In other markets, the existence of large profitable market would attract new entrants to the market. These entrants would bring in a lot more competition, forcing innovation and development of new drugs to try and gain the competitive advantage. This is not the case due to the patents that block newcomers. As a result of this, drug companies free of any significant competition set prices that guarantee huge profits.

The marketing of their products by drug companies has increasingly taken on a larger share of expenditure. In the year 2000, these companies spent an average of 12% of revenue on R&D (Figure 1) compared to Marketing and administration at 30% of revenue. In fact 8 of the 10 top drug companies spent more on marketing than R&D. This implies that that of the $800 million spent in bringing a drug to market, only $96 million is used on R&D while $240 million is spent on marketing and appears to be a disproportionate. This is also supported by 1998 data during which the industry spent $12.7 billion (60%) on drug marketing out of $21.1 billion R&D expenditure. The question that needs to be answered is; should the drug companies be guaranteed the same return on their marketing and lobbying expenditures as they would on their R&D?

The industry has argued that access to better and more modern drugs has improved the quality of life of Americans. However, a comparison of drug sales per capita to the average life expectancy of American indicates that they spend the most on drugs while their life expectancy is the lowest amongst 8 first world countries. (Figure 2). This implies that Americans may not derive value for money spent on drugs.

Medicare, the federal health medical program is legally barred by law from negotiating with drug companies to obtain a better price for drugs. The plan accepts the prices quoted by drug companies that are invariably higher than prices paid by retail pharmacy chains. A health and Human Services report in 2001 said Medicare disbursements for some drugs were $761 million higher than wholesale prices offered to pharmacy chains. The Veterans Affairs (VA) backed by congressional laws gives it the power to negotiate drug prices. This they do aggressively due to the large buying power it has because of the volume of drugs they are willing to buy from manufacturers. They are given deep discounts sometimes up to 70% lower than retail prices offered to Medicare and private medical insurance schemes (Carpenter, 2004).

Opponents of the drug industry have questioned the rationale behind the law barring Medicare from negotiating prices when the VA is allowed to. The federal government does this on the behalf of the VA and other federal beneficiaries. Why not for Medicare?

The reason for this is not far fetched. The drug industry spent an average of $54.4 million on lobbying members of congress to kill proposed bills that would hamper their profits. There are more than 600 lobbyists hired by the industry to project their own agenda. This number is twice as large as the number of congressmen. In addition to this, between 1991 and 2002, the drug industry has donated $57.9 million to political campaigns that back candidates favorably disposed to the industry. A proposal was made to restructure Medicare in order to offer more prescription drugs benefits to seniors who have been forced to pay for medication out of their own pockets because they lack insurance that covers medication. This bill was killed in congress as a result of lobbying by the drug industry that fears that if the federal government becomes a bulk buyer of drugs, it will lead to deep discounts on drug prices and erosion of their profits.

The purchase of drugs in Canada by Americans has also come under heavy attack by the drug industry. A proposal to legalize these purchases by amending the Medicare bill was put forward in July 2003. This amendment was however not passed due to the FDA and powerful congressmen who claim that the importation of drugs from Canada and other industrialized nations by any other entities apart from the industry itself would prove uncontrollable because of counterfeiting and unapproved FDA drugs. In response to this Pfizer, the world's largest drug company has even taken steps to resist this Canadian trade (Managing Intellectual Property, September 2003 issue 132 page 8). It has decided to stop selling its drugs to wholesalers and will only deal directly with Pharmacies and many more manufacturers have followed suite. This is due to the fact that Americans by these drugs from the wholesalers either physically or over the internet.

The Drug industry manufactures most of its drugs outside the country in Ireland, Sweden, France, Belgium France and Singapore. They do this due to the generous tax breaks they are given in these countries as an incentive to invest in their country. These drugs as are then imported by the industry into America and sold at the current prices. However, the same drugs are sold in the countries were they are manufactured as well as Canada by these same companies for as much as 60% less. The United States trade deficit in drugs due to this importation has climbed from zero to about $15 billion between 1995 and 2002 (U.S. Department of commerce) and is still climbing. This could imply either of two things; the drug industry is reaping huge profits from these drugs or the American people are subsidizing the drugs sold to the rest of the world. However, based on the profit margins declared by companies, it is most likely that the latter is the case.

THE DRUG INDUSTRY PERSPECTIVE

The drug industry has countered with arguments of its own. The cost of drugs it claims should be viewed in context. The savings achieved by reduced hospitalization due to better drugs have been calculated at a ratio of 1 to 3.65. This means that for every $1 spent on drugs, there is a reduction of $3.65 in hospitalization costs (Lichtenberg, 1984). This has been documented by other researchers. This evidence suggests that the net savings to the federal government and to individuals will be over $2.5 for every dollar spent. This savings can then be re-directed to other parts of the economy where it will be more efficiently used. The reduction in hospitalization could also be viewed from the quality of life perspective. Fewer hospital visits, better acting drugs and fewer surgical procedure means less traumatization for people.

Proponents of the current market pricing argue that the pricing is what drives research and Americans have access to new medical advances and breakthrough drugs at a faster pace than observed in other countries where the industry is regulated. They point out that in the last 20 years, the United States has produced over 50% of the worlds leading pharmaceuticals and currently make all the top ten world's best selling drugs (Bailey, 2001). They also argue that taking away the profits will reduce the incentive to do research for breakthrough drugs for treatment of diseases. This would reduce the competitive position of the United States compared to the rest of the developed world and would ultimately be to the detriment of the populace.

The industry claims that it costs an average of $800 million and 12 years to bring a drug to market. This cost includes the opportunity cost of capital tied up for the years used in research and clinical trial. Consequently, the rates of return should be adjusted for this opportunity cost which could have been used to making more money for example by investing in securities.

The FDA is accused of bearing responsibility for some of this cost. The approval process is particularly slow. While no one wants an unsafe drug on the market, it has often been blamed for unwarranted delays. A study of drugs introduced in the United states and United Kingdom between 1997 and 1987 showed that there were more drugs first available in the U.K. than the U.S. this delay ranged from a period of 1 year to as much as 3 years. The FDA often demands for elaborate clinical trials and test for these drugs as they do not want to be held responsible for approving drugs that would kill even one person. However, what has not been quantified is the number of people who have died because of the delays in approving much-needed drugs.

The drug prices should also be viewed in the correct perspective. The overall inflation rate has risen by 19% while drug prices rose by 18.1%. This indicates that the rising cost of drugs is not out of line with what obtains in the general economy. The reason this issue has been brought to the fore is due to the cutback in federal government spending as well as the rising life expectancy in the United States. This has created an aging population with a higher demand for medication to keep healthy and is indeed one of the reasons for the proposed amendment to the Medicare bill.

RECOMMENDATIONS

The accusations and counter accusations in this high stake issue have been widely debated for a long time. However, the real truth and possible solution(s) to this problem would most likely lie somewhere in middle ground between both sides.

It has been suggested that a possible solution would be for the federal government to propose prices for drugs which are based on comparing the cost of drug development plus a "reasonable profit". This cost model has already been extensively used for Utility and Energy companies regulated by the various states. The federal government when dealing with its contractors has also used it. An example of this would be the logistics supply contracts awarded by the military that guarantees contractors a fixed percentage of profit.

The federal government already spends over $25 billion dollars on drug research through the National Institute of health (NIH). Another $5 billion is also spent by private charities and research institutes. This funding is currently focused on basic research to determine viable compounds and molecules that can be synthesized further into new drugs. These discoveries are then turned over to the drug industries for further development and clinical trials. The federal government through the NIH can fund the discoveries up till the production stage and then place this in the public domain (Baker, 2003). Generic drugs can then be produced by interested drug companies. This will level the playing field and have the effect of bringing down drug costs. This will effectively remove the ambiguity in the R&D costs that has become a major issue in this debate and also reduce the retail prices.

CONCLUSIONS

Price control systems have not always worked because they actually reduce the incentives for people to invest in such businesses. These controls would merely make investors shift their funds to other sectors of the economy without controls to try and maximize their return on investment. This would seriously retard the growth and competitive advantage of the United States and also reduce discovery of breakthrough drugs to treat currently incurable diseases because drug companies determine their research priorities by expected profits.

The common ground that could be found for both sides of the debate would be publicly funded research and clinical trials with the production of generics by the drug industry. This should inevitable lower the profits of the industry but maybe not as much as what price controls would. The drug industry may not be favorably disposed to this solution. However, the growing resistance to their sector of the economy may ultimately force them to compromise their present stance if they are to survive in the near future.

Figure 1. Research and Development as a Percentage of Revenue:
Fortune 500 Drug Companies 2000 Revenue Dedicated To R&D Marketing And Profit

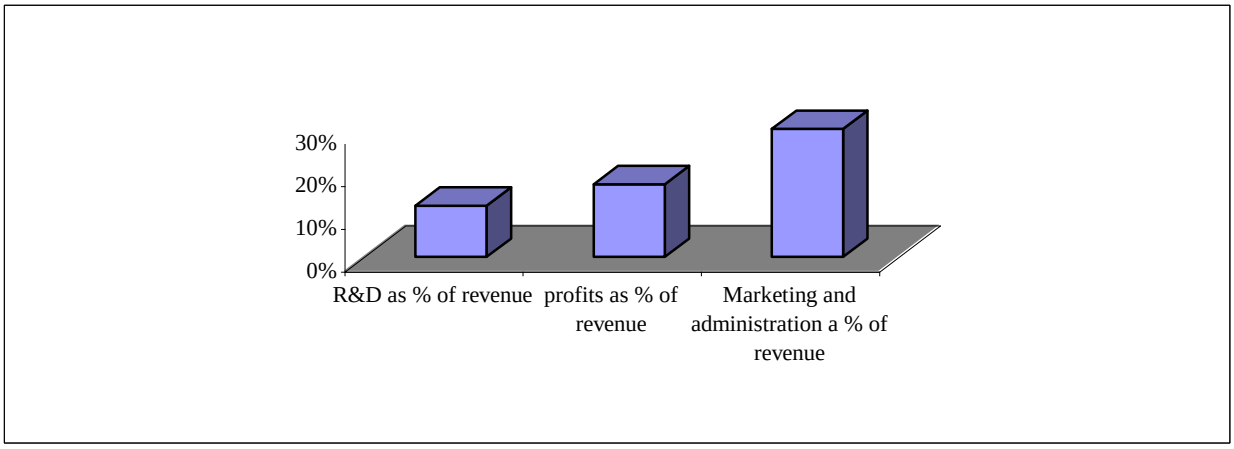
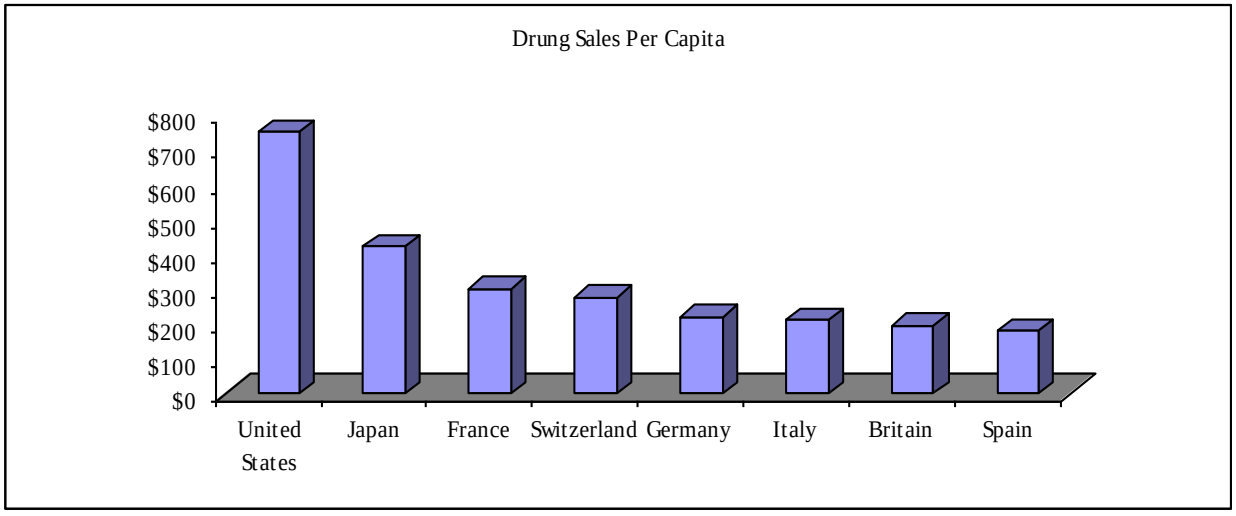


Figure 2. Drug Sales Per Capita For Eight Developed Countries



The U.S. has the lowest life expectancy of 77 years but spends the most on drugs. Spain, the lowest spending country (30% of US) has a life expectancy of 79 years

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